Volume 39 | Issue 4 Article 13

June 1933

Taxation--Revocable Trust in Income Tax Evasion

Frederick H. Barnett
West Virginia University College of Law

words "and his heirs" necessary at common law for the creation of a fee-simple. Any supposed intention of the parties to the contrary cannot penetrate the stone wall of intentions technically expressed.

—ROBERT T. DONLEY.

TAXATION — REVOCABLE TRUSTS AND INCOME TAX EVASION. — The plaintiff created trusts in December, 1922, in favor of her daughter and her nephew, for the duration of the life of the settlor or of the beneficiaries or of the minority of the latter, whichever period should first expire, the settlor being one of the two trustees. The income was to be paid to the beneficiaries in the discretion of the trustees or to the settlor for the use of the beneficiaries. The settlor reserved "the right to revoke the trust estate prior to the determination thereof, upon and at the expiration of twelve months and one day after notice of revocation as hereinafter set forth". In 1928 the trusts terminated upon the attainment of majority by the beneficiaries and on the next day new trusts were set up on the same terms for the life of the beneficiary or the settlor, whichever proved shorter. The settlor was taxed on the income for the year 1928 and on appeal the court held that such tax was improper under the statute set out below,[1] Augustus N. Hand dissenting. *Langley v. Commissioner of Internal Revenue.*[2]

The device of a revocable trust is but one of many used by persons who wish to avoid a surtax by dividing the income in such a way that such divisions fall into the lower brackets of the rate scale, thus securing a lower tax rate and in some cases complete evasion of any tax whatever, while at the same time substantial enjoyment of the income is retained in the settlor. Another device is the formation of a partnership by the husband including the wife and minor children. The income is equally divided and each files a separate return thus avoiding the higher tax rate. In some instances stockholders in a corporation set up a partnership, composed of their wives, which is used as a selling agent for the corporation, thereby reducing the profits of the corporation which

[1] "Where the grantor of a trust has, at any time during the taxable year, either alone or in conjunction with any person not a beneficiary of the trust, the power to revest in himself title to any part of the corpus of the trust, then the income to such part of the trust for such taxable year shall be included in computing the net income of the grantor". Revenue Act 1928, § 166, 45 STAT. 840, 26 U. S. C. A. § 2166 (1926).

[2] 61 F. (2d) 796 (C. C. A. 2d, 1932).

the husbands would have reported as dividends. A substantial part of this income thus goes to the partnership where it becomes distributable to the wives who file separate income tax returns. A more clearly colorable method is the so-called "wash sales" of stock. In this instance the sale is made to the wife of the holder at a certain price and immediately such stock is re-purchased at a much lower figure and the difference is reported as a deductible loss thus diminishing the amount of taxable income. This device has been substantially outlawed by statute.[3]

Though a taxpayer may go the full limit of the law to avoid or minimize taxes,[4] there are many points where no clear line marks the boundary. So it was in the principal case since the settlor could evade the statute entirely every other year and still have substantial control of the principal and income by giving the required notice and, after the determination of the trusts, executing anew the same type of agreement. To forestall this very possibility Judge Hand insisted that the clause "at any time during the taxable year" qualified the word "power" rather than the words "to revest".[5] In *Clapp v. Heiner*[6] the court held the income taxable to the settlor who had provided that the trust might be revoked upon six months notice, but the very fact that there the revesting might occur in the tax year during which the power was exercised distinguishes that case from the present one.

In a situation like the principal case the practical avenue of escape is by amendment of the statute. This would relieve the court of the temptation to exceed the legitimate limits of statutory construction in order to prevent tax evasion.[7] As a matter of fact

---

[3] 45 STAT. 826, § 118 (1928), 26 U. S. C. A. § 2118.

[4] Bullen v. State of Wisconsin, 240 U. S. 625, 36 S. Ct. 473 (1916).

[5] Section 219 (g) of the bill as it originally came from the House of Representatives read: "Where the grantor of a trust reserves a power of revocation which if exercised would revest in him title to the corpus of the trust then the income of such trust shall be included in computing the net income of the grantor." The Senate Committee reported that: "The subdivision of the House Bill has been re-written in order that there shall not be taxed to the grantor the income of a trust as to which the grantor has a power of revocation subject, however, to a condition which has not yet happened." Judge Hand insisted that the condition meant is one of substance and not a mere notice of an intention to revoke which amounts to an exercise of the power itself.

[6] 51 F. (2d) 224 (C. C. A. 3d, 1931).

[7] As a practical matter it would seem that the natural meaning of the sentence requires the entire phrase "power to revest" to be taken as an inseparable unit and not broken apart as was done in the principal case. Such reading of the words then clearly sustains the result reached by the majority. The fact that the income could be paid to the settlor for the use of the beneficiaries may explain in part the fact that Judge Hand was at some pains to work out a rational construction of the statute which would prevent the settlor from escaping liability.

such statutes can be and have been quickly and easily amended.[8] It would probably suffice to provide that the income should be taxed to the settlor if he could revest title in himself within a period deprivation of the income of which would be a substantial economic loss to the settlor. Three years may be suggested as an appropriate length for the period.

—FREDERICK H. BARNETT.

TRUSTS — POWER OF COURT TO REQUIRE TRUSTEE IN DEED OF TRUST TO INSURE. — Pending a chancery suit charging usury in loans secured by a deed of trust for the benefit of creditors, the chancellor upon the suggestion of the trustee ordered him to procure insurance on buildings covered by the trust deed, which contained no provision for insurance. The order constituted insurance premiums part of the cost of the suit. The trustee insured for one year but the buildings were destroyed by fire one day after the expiration of the policy, and before the usury proceeding was finally settled. The grantor of the deed of trust, purporting to act for himself and the beneficiaries thereunder, sought to hold the trustee liable for the failure to renew the policy. A decree overruling a demurrer to the bill was reversed on appeal. The court held, in effect, that the decree requiring insurance was void for the want of jurisdiction. *Kile v. Forman.*[1]

From the facts as stated in the opinion, it seems that the court could have disposed of the case on the ground that the grantor was not a proper party to bring suit. For if the grantor had parted with his title, conveying to the trustee absolutely, the trustee's obligations were only to the beneficiaries; and on the other hand, if the conveyance were a deed of trust in the nature of a mortgage, the grantor remaining in possession and control, as apparently he did, the trustee owed him no fiduciary responsibilities, except those expressly designated in the trust instrument.[2]

But as between a beneficiary and a trustee, the latter owes

[8] Thus on March 2, 1931, the Supreme Court decided that the estate of a settlor had been improperly taxed. A bill to amend the statute was introduced into the House of Representatives the next day, was passed unanimously by both Houses of Congress and signed by the President on the same day. See note (1931) 37 W. VA. L. Q. 438.

[1] 167 S. E. 744 (W. Va. 1933).

[2] In the absence of agreement or covenant no relation of trust or confidence exists between the beneficiary and trustee on one side and the grantor of a deed of trust on the other. Summers v. County of Kanawha, 26 W. Va. 159, 171 (1885).